

Board of Governors of the Federal Reserve System

**REPORT ON THE AUDIT OF
THE BOARD'S
CONSUMER COMPLIANCE
EXAMINATION PROCESS**



OFFICE OF INSPECTOR GENERAL

April 26, 1996

The Honorable Lawrence B. Lindsey
Chairman
Committee on Consumer and Community Affairs

We are pleased to present our final *Report on the Audit of the Board's Consumer Compliance Examination Process* (A9508). We conducted our audit to evaluate the efficiency and effectiveness of the consumer compliance examination process and to identify opportunities to reduce regulatory burden.

Overall, we found that the Reserve Banks generally examine financial institutions within the Board's guidelines. We also found that the Board's Division of Consumer and Community Affairs continues to demonstrate its commitment to maintaining a responsive and relevant consumer compliance program.

Although established guidelines for consumer compliance examinations of financial institutions are generally followed, we believe that opportunities exist for improving the efficiency and effectiveness of those examinations. Our report contains recommendations to extend the examination frequency, determine whether nonbank entities of bank holding companies should be subject to consumer compliance examinations, improve the level of documentation of examination workpapers, and increase the use of the Consumer Affairs Report of Examination Data System by the Reserve Banks. In addition, the report includes nine recommendations to improve the use and technical design of the logistic regression model.

The Director of the Division of Consumer and Community Affairs and the Director of the Division of Research and Statistics' joint response to our draft report (see appendix 3) indicates agreement with eleven of the fourteen recommendations. They concurred in part with the remaining three. We plan to follow up on implementation of our recommendations and report any exceptions as part of our future audit activities.

We are sending a copy of this report to each member of the Board and to selected staff. Copies of this report are available to the public and a summary will appear in our next semiannual report to the Congress.

Sincerely,

Brent L Bowen
Inspector General

Enclosure

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EXECUTIVE SUMMARY

Background

Since the late 1960s, Congress has enacted a number of consumer protection and civil rights laws directly related to the activities of financial institutions. While the Board of Governors of the Federal Reserve System (the Board) continues to encourage voluntary compliance with these laws, it has also established a program of special examinations to determine compliance by state member banks (SMBs) and foreign bank organizations. The Board's Division of Consumer and Community Affairs (C&CA) carries out the Board's responsibilities in the area of consumer protection. The Board's Committee on Consumer and Community Affairs, which consists of three governors, has oversight responsibility for C&CA and is currently chaired by Governor Lawrence B. Lindsey.

The Board has delegated many of its supervisory activities to the Reserve Banks for implementation while C&CA's Reserve Bank Oversight unit oversees the Reserve Banks' examination programs. The unit develops examination policies and procedures, administers an examiner training program, and ensures that Reserve Banks adhere to the Board's examination and enforcement policies designed to ensure effective supervision of SMBs and certain foreign bank organizations with respect to the nation's consumer protection laws and regulations. It also participates in Federal Financial Institutions Examination Council (FFIEC) activities to promote consistency among the federal banking agencies.

To facilitate a uniform and efficient consumer compliance examination program, in 1979 C&CA created the *Consumer Compliance Handbook (Handbook)* which provides the examiners with guidelines for conducting compliance examinations and investigating consumer complaints. The *Handbook* includes summaries of the consumer laws and regulations, along with the uniform FFIEC examination procedures and internal control checklists.

Audit Purpose

We conducted our audit to evaluate the efficiency and effectiveness of the consumer compliance examination process and to identify opportunities to reduce regulatory burden. To accomplish this objective we assessed whether consumer compliance examinations are conducted with the appropriate scope and frequency, reviewed the tools the Reserve Banks use to test compliance with fair lending laws and regulations, and analyzed the enforcement actions taken by the Reserve Banks and the Board based upon the findings documented in the examination workpapers and the report regarding fair lending compliance. We focused particular attention on the System's use of a newly designed, and

recently implemented logistic regression model, (the regression model) which uses advanced statistical techniques to test compliance with fair lending laws and regulations.

Results

Overall, we found that the Reserve Banks generally examine financial institutions within the Board's guidelines as outlined in the *Handbook*. We also found that C&CA continues to demonstrate its commitment to maintaining a responsive and relevant consumer compliance program. For example, the Director of C&CA recently established the Consumer Affairs Steering Committee,¹ which will be reviewing how the Federal Reserve is carrying out its consumer compliance responsibilities. One of the committee's goals is to identify opportunities for improving the efficiency and effectiveness of the consumer compliance examination process. We endorse the establishment of this committee and believe that the committee can be instrumental in implementing our recommendations as it goes forward with its review of the examination process. Specifically, we have recommendations regarding the frequency, scope, and level of documentation of examinations; Reserve Bank access to examination data; and the use and technical design of the regression model.

Regarding the Board's policy on examination frequency, we believe the current examination frequency schedule could be extended and a risk-based consumer examination procedure developed without increasing the risk to the System. The vast majority of SMBs consistently receive a satisfactory or better rating at each examination. Furthermore, the Federal Reserve has the shortest examination frequency schedule of any of the bank regulatory agencies.

In addition, we found that the Federal Reserve does not test compliance with fair lending laws and regulations in nonbank subsidiaries of bank holding companies (BHCs). Board staff have considered this issue on a number of occasions, but to date there has been no final resolution regarding the role the Board should have in examining these entities. Because these institutions play a significant role in granting credit, we believe the Board should determine whether nonbank entities of BHCs should be subject to consumer compliance examinations.

Regarding the examination process, we found that the level of documentation of examination workpapers at the five Reserve Banks in our sample did not always meet

¹The Community Affairs Steering Committee established six subcommittees that have been assigned specific areas for review: 1) Subcommittee on Interstate Banking Issues, 2) Compliance Examination Review Subcommittee, 3) Staff Training, Utilization, and Career Development Subcommittee, 4) Consumer Automation and Reporting Subcommittee, 5) Nonbank Issues Subcommittee, and 6) Industry Outreach Subcommittee.

Handbook standards. The variances we identified made it difficult to determine if all of the procedures had been performed. In addition, we noted that some Reserve Banks have made changes to existing model worksheets or have developed new worksheets. We believe that the Director of C&CA should provide additional guidance to the Reserve Banks to ensure that the results of consumer compliance examinations are adequately documented and should implement a procedure to identify and review "best practices" developed by the Reserve Banks. We also found that most Reserve Banks conduct a review of their examination workpapers to ensure that all tests were completed and that the workpapers adequately support the findings documented in the report of examination. However, there are differences among the Reserve Banks in the extent and timing of the reviews performed. We believe that the Board should provide the Reserve Banks with guidance to ensure that minimum standards of review are maintained Systemwide.

In the area of automation, we found that the Reserve Banks often have difficulty accessing data from the Board's management information system. After completing each examination, the Reserve Banks enter information regarding the examination into the Consumer Affairs Report of Examination Data System (CARES). Although the data included in CARES can be used by the Reserve Banks for planning, budgeting, and other administrative activities, we found that the Reserve Banks cannot easily access the information and that some Banks have developed systems that duplicate information in CARES. We believe the Board should improve the Reserve Banks' access to the data contained in CARES.

With the assistance of outside experts, we analyzed the regression model used to test compliance with fair lending laws and regulations at certain financial institutions. As a result of this work, we make nine recommendations. One recommendation addresses the need to determine the costs associated with using and refining the regression model and when the regression model should be used; three recommendations address opportunities to use the regression model more efficiently and take advantage of more of its features; and five recommendations concern technical enhancements designed to improve the regression model's efficiency and effectiveness. A description of the regression model and the specific recommendations begin on page 19 and are supplemented by appendix 1.

Analysis of Comments

We provided copies of this report to the Directors of C&CA and R&S for their review and comment. The directors' combined response, which is included as appendix 3, indicates agreement with eleven of the fourteen recommendations. The directors concurred in part with the remaining three recommendations; areas of disagreement are generally minor in nature.